

Course: The Economics of European Integration

Revised 19/10, 2023

Euro-crises, Brexit, rising populism and nationalistic parties, migration, security threats, refugee crises, internal conflicts— there has been no shortage of problems for the European Union (EU). On top of this, Covid and soaring energy prices following the Russian invasion of Ukraine threaten the economic recovery. Yet, the EU has survived past crises, and post-Covid, it has equipped itself with new policy instruments unthinkable only a few years ago.

This course will give you an overview of the long and windy road of European Integration, from past to present.

We start with the history of the European Union (EU) — beginning at the end of World War II and proceeding up to the present. We introduce the leading European institutions, their roles, and their evolution. We describe the enlargement from the original six to 28 and then to the present 27 members.

We will highlight the United Kingdom’s complex relationship with Europe: first staying out, then reluctantly joining —and then in 2016, on a small margin and after a volatile and intense campaign—choosing to leave the EU. We discuss the Trade and Cooperation Agreement between the EU and the UK and the Withdrawal Agreement with the contentious Northern Ireland protocol (and the fact that the UK had three Prime Ministers during 2022).

Part I: Real Integration

European Integration has foremost relied on economic integration. The idea was that deeper economic integration would draw Europeans into closer and more intricate economic exchanges. Economic integration would eventually promote a shift to tighter political integration. A closer political integration, in turn, would ensure a peaceful and stable future in Europe.

In the Treaty of Rome in 1957, France, Germany, Italy, and the Benelux countries agreed to the so-called “four freedoms”: among the six, there would be free movement of goods, services, people, and capital. To administrate this European Economic Community (EEC), the six agreed to create common institutions such as the European Commission, the European Parliament, the Council of Ministers, and the European Court of Justice.

The first part of the course looks at this early period of integration—the time before the Maastricht Treaty in 1992—and deals with the economic impact of the four freedoms.

We will first show how the free movement of goods creates gains to integration under trade driven by comparative advantage. This “old trade “theory” explains why countries export some goods and import other goods (inter-industry trade). We will also study more recent trade models with scale economies, product differentiation, and imperfect competition, which explain trade in similar types of goods and services (intra-industry trade). The latter “new

trade theory” provides a solid understanding of the strong growth in trade and income that followed the initial integration in Europe in the 1950ies and 1960ies.

We will show that the four freedoms lead to a more efficient resource allocation conducive to economic growth. Improved economic performance of the member countries makes it more attractive to other countries to seek membership, and the more countries that join, the worse it becomes to be left outside. Enlargement becomes self-sustaining. Successive enlargements occur over the years. The last is the Eastern enlargement which follows the fall of the Iron Curtain.

While integration creates overall gains through higher incomes and wealth, there are also “winners and losers.” Indeed, when we look at the budget of the European Union, we note that most of the EU’s limited resources go to redistribution between different groups, regions, or countries. European integration does not take place in isolation. In concluding the first part of the course, we discuss the challenges of migration, globalization, automation, and offshoring of production to low-wage countries. We relate these findings to the outcome of the Brexit referendum, the resistance against migration and free movement, and the rise of populist and nationalistic parties in Europe.

Part II: *Monetary integration*

The second part deals with monetary integration and adopting the single currency—or the EURO—following the Maastricht Treaty in 1992.

The single currency can be viewed as a natural step in the integration process to enhance economic efficiency further and increase growth in Europe. But the decision to adopt the single currency can also be viewed as a political deal between France and Germany, where the EURO was the ultimate price France demanded to agree to German unification. 19 out of the 28 present member countries in the EU have now adopted the EURO.

The financial crises in 2007 strongly impacted the EURO zone and strengthened rising skepticism against the European project. To understand why the EURO crisis became so deep, we first review basic macro concepts such as interest parity, purchasing parity, and the determination of exchange rates. We then look at how the choice of the exchange rate regime affects a government’s possibilities to pursue independent economic policy and relate this to the creation of the EURO. We note that the Eurozone members share a central bank with behavioral rules substituting for a common fiscal backstop and discuss the drawbacks of such a system.

We look at the theory of optimal currency areas, which reveals why many economists (especially Americans - with otherwise very different views, such as Milton Friedman and Paul Krugman) were very skeptical of the EURO project. We discuss whether the core problem with the EURO even lies in philosophical differences between the founding countries of the Eurozone, particularly Germany and France. We also show how the omission of the financial sector and financial stability from the Maastricht Treaty contributed to the EURO crisis.

We end with a discussion of the future of the EURO and the EU and suggestions to reform and revive the European integration project. Finally, we will also discuss how the present

COVID-19 has contributed to necessary reforms in the EU, where the new recovery fund NG-EU may be the start of a new EU-wide fiscal policy financed by common borrowing.

Upon completion of this course, you will be able to:

- Explain **why economic integration** was chosen in Europe in favor of political integration.
- Have a basic understanding of the **leading EU institutions** and **the historical evolution** of the EU institutions.
- Explain how **Europe has gained from integration** using economic theory (Ricardian comparative advantage, new trade theory models of imperfect competition and scale economies, and Solow-type growth models).
- Explain how integration can make **some groups worse off** and how this has shaped **EU policies**.
- Assess the EURO project using the theory of **optimal currency areas**.
- Explain why the aftermath of the **financial crises** has been **worse in Europe** than in the US.
- Discuss the **crises in Greece and the Southern European** countries and relate them to the EURO project.
- Discuss the reasons for and consequences of **Brexit**
- Discuss how the EU and its member countries have handled the **EURO and COVID crises and how they** may shape the EU in the future.

Practical Information

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Lectures: Friday, 09.15-12.00
Room: See below
Visit hours: Friday, 12.00 (after the lecture)

Prerequisites: One course in macroeconomics, one in microeconomics, and one in calculus.

Examination and Grading: A maximum of 100 points.

All students will have to do **four mandatory problem** sets during the course. There will be a **mid-term exam** as well as an **end-term** exam. **Active** class participation is also required.

40 points are based on the problem sets, 30 on the mid-term exam, and 30 on the end-term exam.

Students can also write **two optional small papers**, which give 5 points each to increase their grade (100 points will still be the maximum).

Problem sets

Students may cooperate when doing problem sets, but you must submit your solution. Remember that problem sets are learning experiences. Try to do it yourself first, and then ask your classmates. This strategy will help you on the mid-term and final exams – if you copy what somebody else did, you won't know what to do on the exams!

Hand in solutions to a problem set in the following lecture (usually, you will have one week to do them). I will go through the answers from 08.15-08.30 to avoid taking time from the class, which starts at 08.30. The run-through of solutions is voluntary to attend.

Lecture notes

- Lecture notes will be posted on the course web: <https://classroom.google.com>
- Lecture notes are used as additional material. I will present most of the material on the whiteboard.

Literature

“The Economics of European Integration”, by Richard Baldwin and Charles Wyplosz, fifth the Edition.

“International Economics”, by Robert C. Feenstra (University of California, Davies) and Alan M. Taylor (University of California, Davies), Worth Publishers, third edition, 2014.

The EURO and the battle of ideas, by Markus Brunnermeier, Horald James and Jan-Pierre Landau. Princeton University Press, 2016.

Course Outline: preliminary!

- 1/9: Room A348 Lecture 1: Overview of European integration and European Institutions. (**BW 1-3**).
- 8/9: Room A538 Lecture 2: Gains and losses from Trade in The Ricardian model, (**F/T 2**). The Eastern Enlargement. *Problem set #1 handed out.*
- 15/9: Room PClab Lecture 3: Gains and losses from trade in the Specific-Factors Model (**F/T 3**). *Problem set #2 handed out.*
- 22/9: Room A348 Lecture 4: (**F/T 6** and **B/W 6**). Trade with increasing returns to scale and imperfect competition. The gravity model with applications.
- 29/9: Room A538 Lecture 5: (**F/T 7, BW 7**). Offshoring of Goods and Services. Globalization, Digitalization and Inequality.
- 6/10: Room A348 Mid-term-exam. (Material: **FT 2-FT3, BW 1-3, F/T 6** and **F/T 7**)
- 13/10: Room A536 Lecture 6: Import Tariffs and trade policy (**FT 8**). **The UK, Brexit and the CAP.** *Problem set #3 handed out.*
- 20/10: Room A350 Lecture 7: Labor market integration and migration. Growth effects of European Integration **B/W 7** . *Problem set #4 handed out.*
- 10/11: Room A536 Lecture 8: Macro groundwork and European Monetary integration. “The impossible trinity” (**BW 13-14**) *Optional problem sets handed out*
- 21/11: Room A328: 08.00-10.00 Lecture 9: European Monetary integration The EURO and optimum currency areas. Swedish crises. (BW 13-16, BHL 1-2)**
- 24/11: Room A328 Lecture 10: Maastricht Treaty and the EURO, Financial markets. The EURO zone in crises. (**BHL 5-8, 10**)
- 1/12: Room A536 Lecture 11: Future of European Economic Integration. (**BW 16-19, BHL 1, 5-8, 10**).
- 7/12: PC lab Final exam. (only material covered after midterm)